

## Confidence and Economic Activities

Consumer and business confidence are economic indicators that are widely followed by financial market participants, businesses, and policymakers. Examples of well-known confidence surveys are the University of Michigan's Surveys of Consumers, the Institute for Supply Management (ISM) Report on Business, and the Bank of Japan's Tankan Business Survey.

From experiences abroad, announced confidence figures that differ from what the market previously expected often exert tremendous influence on stock market movements on its release date. Typically, consumers and businesses that are confident about the future spend more than those who lack confidence given the same environment, which in turn translate into different rates of consumption and investment growth. For this reason, many countries employ consumer or business confidence indices as a component in their indices of leading economic indicators.

In addition, a timely release of the confidence index, relative to other economic indicators is one reason supporting the importance of the confidence index. For example, the University of Michigan's consumer survey results for a given month are released at the end of that month, while the personal consumption expenditure report, which measures how much consumers actually spend in that same month, is released at the end of the following month.

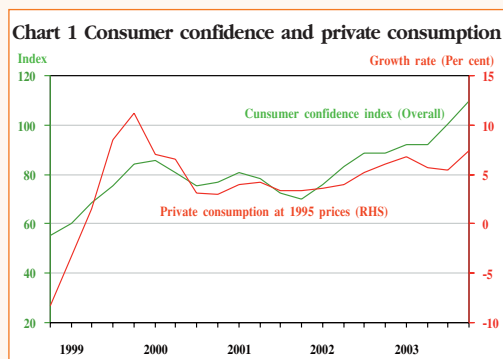
Nevertheless, there are controversies among economists regarding the usefulness of confidence figures. A group of economists believe that confidence figures are not economic indicators. Glenn Hubbard, former Chairman of the Council of Economic Advisers under President George W. Bush, once told the press, "Economists will be watching what consumers do more than what they say."

One reason economists like Hubbard reject confidence figures is because the relationship between confidence and economic activities is not grounded in standard economic theory. Indeed, confidence factors play a small, if any role in most derivations of neoclassical decision rules for households and firms. Even John Maynard Keynes had to attribute the unexplainable aspects of economic decision-making to the so-called "animal spirits."

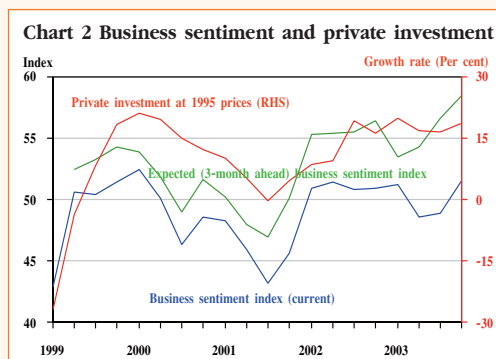
To explain the relationship between confidence and economic activities, one would need to appeal to psychological economics, which portrays private agent spending decision as a function of the ability and willingness to spend. According to the psychological theory, willingness to spend depends on the confidence that consumers and businessmen have about their future financial positions. In this context, confidence figures reflect respondents' assessment of risk to future financial positions posed by economic factors such as interest rate trends as well as non-economic factors such as political unrest or wars.

In Thailand, regular surveys of consumers and businesses started after the 1997 economic crisis with the objective of providing both the public and the private sector with additional indicators of overall economic and business conditions. At present, the MPC uses results from three confidence surveys as inputs to the economic and inflation outlook forecast. They are the University of the Thai Chamber of Commerce's Consumer Confidence Survey, the Bank of Thailand's Business Sentiment Survey, and the Federation of Thai Industries' Thai Industries Sentiment Survey. The confidence indices derived from all three surveys are diffusion indices. This type of index has one reference or mid-point value. An index number above, equal, or lower than the reference value means the respondents view the situation as better, unchanged, or worse, respectively. The Bank of Thailand's indices have a reference value of 50, while the other two have a reference value of 100.

## Association between confidence indices and private sector spending in Thailand



Source: The University of the Thai Chamber of Commerce and NESDB



Source: NESDB and Bank of Thailand

Charts 1 and 2 suggest that the common practice of using confidence indices to explain private sector spending does have some merit. Growth rates of real private consumption and real private investment seem to move in tandem with consumer confidence and business sentiment indices, respectively. (Quarterly index values are calculated as averages of monthly index values)

A more precise relationship between confidence indices and real private consumption and real private investment can be obtained by examining cross-correlation coefficients between the indices and respective domestic demand components. Table 1 shows that the Overall Consumer Confidence Index appears to be a coincident indicator of real private consumption (the index correlates most with real private consumption growth of the same quarter). In contrast, Table 2 shows that Business Sentiment Indices appear to be leading indicators of real private investment (the indices correlate most with real private investment growth of the following quarter).

**Table 1 Correlation between the Overall Consumer Confidence Index and real private consumption growth (% $\Delta$ C) at different leads and lags, 1998 Q4-2003 Q4**

	% $\Delta$ C(-3)	% $\Delta$ C(-2)	% $\Delta$ C(-1)	% $\Delta$ C	% $\Delta$ C(+1)	% $\Delta$ C(+2)	% $\Delta$ C(+3)
Overall Consumer Confidence Index	0.572	0.673	0.706	0.720	0.577	0.057	0.531

Note: The number in parenthesis after % $\Delta$ C, when negative means, previous quarters, when positive means, following quarters. No parenthesis means the same quarter. The highlighted cell indicates the timing relationship for which the correlation coefficient is highest.

**Table 2 Correlation between the Business Sentiment Indices and real private investment growth (% $\Delta$ I) at different leads and lags, 1999 Q1-2003 Q4**

	% $\Delta$ I(-3)	% $\Delta$ I(-2)	% $\Delta$ I(-1)	% $\Delta$ I	% $\Delta$ I(+1)	% $\Delta$ I(+2)	% $\Delta$ I(+3)
Business Sentiment Index (Current)	-0.010	0.178	0.404	0.685	0.794	0.649	0.274
3-month ahead Business Sentiment Index	-0.091	-0.036	0.169	0.543	0.793	0.763	0.555

Note: The number in parenthesis after % $\Delta$ I, when negative, means previous quarters, when positive, means following quarters. No parenthesis means the same quarter. The highlighted cell indicates the timing relationship for which the correlation coefficient is highest.

In summary, confidence and growth of economic activities are closely associated with each other, as evidenced by graphical movements and simple statistical relationships between confidence indices and growth of private sector spending. Such associations are also found in other countries.